Global Matters Weekly

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Premium Grade

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Chart of the Week

Source: Bloomberg Finance L.P., as at 24 January 2025

What this chart shows

This chart illustrates the real equity risk premium (ERP) of US equities, by plotting the inverted 1-year forward price-to-earnings (P/E) ratio (i.e. forward earnings yield) of the S&P 500 and subtracting the yield on 30-year US inflation-linked bonds. The result provides a historical perspective on how the compensation for taking equity risk, relative to the long-term real risk-free rate, has evolved over time.

A higher ERP implies that equities are offering greater compensation for risk, often due to pessimistic economic expectations or market volatility. Conversely, a lower ERP suggests confidence in growth prospects or an increased appetite for risk-taking, potentially signalling frothy equity valuations or tighter monetary conditions.

Over the period we can see key inflection points, such as the dot-com bubble (1999-2000), the global financial crisis (2008-2009), and the market turbulence following the COVID-19 pandemic (2020). Sharp increases often correspond to heightened investor uncertainty, where falling bond yields and reduced equity valuations boost the ERP. Conversely, declines suggest improved investor confidence, rising bond yields, or elevated equity valuations reducing the risk premium. The recent trajectory has been a combination of both these factors, increased equity valuations despite rising real rates.

Why this is important

A long duration asset such as a 30-year inflation linked bond offers a meaningful comparator when assessing the risk you are willing to bear as an equity investor. In the case of US equities, investors are only receiving a 2-percentage point risk premium over and above long-term inflation protected returns of over 2%. While earnings growth may be enough to offset both inflation and valuation compression over a period of three decades, the intervening period can be painful for investors.

For multi-asset investors, this measure can provide a key consideration for portfolio allocation and valuation analysis. The era of low interest rates distorted the investment landscape post the global financial crisis of 2008, making equities a consistently attractive option from a relative perspective, with few alternatives. The increase in interest rates over the last three years has inflicted significant pain on bond holders over this period of normalisation. While today's 30-year US real yield of around 2.5% may not be a highly compelling proposition on an absolute basis, they are at their most competitive versus equities for over 20 years. This provides genuine diversification opportunities for investors, particularly in the light of elevated equity valuations.

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